

COMMENT

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Registered Education Savings Plans

Saving in advance of a need makes financial sense. For example, starting a sinking fund or savings plan early can help parents fund the cost of higher learning for their children. Without an established pool of funds, many families would have a hard time finding the cash flows needed to finance education expenses. With an important need such as education, and a gap in the necessary cash flow, the result is that many families turn to an alternative funding source — debt — in order to provide for their children’s education. The long-term implication is that this debt creates a legacy that needs to be repaid over time. Parents may be forced to delay retirement, and children may struggle with significant debt early in their careers.

The federal government revamped registered education savings plans (RESPs) in 1999, in an effort to encourage taxpayers to save for the cost of educating their children. Over time, the rules have been enhanced and the savings incentives increased. Currently, if a parent can contribute \$2,500 per year into an RESP on behalf of his or her child, a government grant of \$500 is also contributed to the plan. The rules contain lump sum, lifetime and catch-up provisions for contributions and access to the grants. There is no income tax on the earnings accumulating in the plan until they are withdrawn.

But are RESPs the only means of providing for the cost of higher education? Do business owners and incorporated professionals have alternatives?

In order for a business person (in this article defined as the owner of a private corporation, either business or professional) to contribute to an RESP, he or she would likely need to take income out of the company. But when withdrawing funds from the company, income taxes have to be paid at either the corporate or personal level.

The following chart shows how \$4,545 of corporate income flows through to become the after-tax amount retained by the shareholder for an RESP contribution:

	Salary / Bonus	Dividend
Pre-tax corporate income	\$4,545	\$4,545
Salary / Bonus	\$4,545	
Corporate tax rate		17%
Corporate tax		\$773
Taxable dividend		\$3,772
Taxable salary / bonus	\$4,545	
Personal tax rate	45%	34%
Personal taxes	\$2,045	\$1,272
Net after tax amount	\$2,500	\$2,500

In order to have \$2,500 after-tax available for an RESP contribution, the government collects \$2,045 in income taxes at either the individual level or the corporate and individual levels combined.

A business person has options when funding higher education for family members. One strategy that should be considered is income splitting. A business person could restructure the company to introduce his or her children, or trusts for the children, as shareholders of the company. Professionals in many provinces can have family members as shareholders of their professional corporation.

Money could then be accumulated in the company with the intention of paying dividends to the child sufficient to fund some or all of the costs of higher education.

If the business person were to set aside \$3,772 annually, and if 4% gross income could be earned annually on those funds, the business could have an investment account worth \$83,478 after 18 years, along with a balance in its refundable dividend tax account of \$7,789. The accumulated savings should be able to support an annual dividend of \$23,389 per year for 4 years. Since the accumulation was from income taxed at the low corporate tax rate, the dividend will be considered an ineligible dividend.

Taking into consideration the amount of the dividends and the tax credits available for students, it is unlikely that the student will incur an income tax liability on these dividends.

If the business person had taken the more conventional route of saving through an RESP, the \$2,500 annual contribution would attract a \$500 grant for a total annual deposit of \$3,000. The annual deposit of \$3,000 per year for 18 years at 4% would accumulate to \$80,014. The accumulated amount of \$80,014 would support an annual withdrawal of \$21,195 per year for 4 years.

Keep in mind, however, that there are numerous caveats to this type of analysis. For example, certain restrictions on this income-splitting strategy may apply where the children receive dividends while

they are minors; accumulating income within the corporation might expose these funds to its creditors; and the accumulation of income within the corporation could impact the eligibility of corporate shares for the capital gains exemption. These and other considerations must be carefully considered with the help of a tax professional when using a corporation to accumulate funds for any purpose.

The above analysis is a quick look at an alternative to the traditional RESP. The income tax collected on earnings used to fund an RESP deposit is far greater than the grant offered by the federal government. By reviewing a business person's options, a viable alternative to an RESP could be ascertained.

I/R 2101.00, 2300.00

Tax Avoidance

Even simple things can have nasty endings. A recent case had four brothers, equal shareholders of an operating company, appearing before the Tax Court of Canada. The brothers had arranged for life insurance to be purchased by the corporation in order to fulfill the funding obligation of their buy-sell arrangement. As the owner of the policies, the corporation named itself as beneficiary. The corporation made a substantial deposit into the contracts in order to prefund the coverage during the good economic times of the corporation. The insurance agent had arranged to make a payment to each shareholder for the privilege of placing the business.

The Canada Revenue Agency ("CRA") sought to tax each of the brothers for a shareholder benefit received. The CRA said that the taxpayers knew that the cash received from the agent was the property of the corporation because it was the owner and paid the premiums on the related policies, and they failed to report the amount of the shareholder benefit received. As well, the CRA sought to impose penalties and interest, saying the taxpayers were grossly negligent in failing to report the shareholder benefit.

The penalty for false statements or omissions is the greater of \$100 and 50% of the taxes avoided. In addition to the taxes and penalties sought by the CRA, there would also be interest added to the bill, starting from the date the liability arose and continuing to the time the taxpayers made a payment. The interest rate charged on overdue taxes is the prescribed rate of interest plus 4%. The prescribed rate of interest has been 1% since the second quarter of 2009, meaning that the interest rate currently charged by the government on outstanding taxes would be 5%. Note that the interest would be compounded on a daily basis until a payment is made.

It is important to note that any penalties and interest charged by the CRA are not tax deductible by the taxpayer and would need to be funded from after-tax cash flow.

In short, the cost of receiving a personal benefit from your corporation can be very high. Consider the following example:

\$1,600	value received from the corporation
\$800	assumed taxes avoided because the transaction was not reported
\$400	potential penalty that could be imposed due to gross negligence
\$400	potential interest charges (assume simple interest of 5% and 5 years)

The taxpayer in the above example would end up paying \$1,600 in taxes, penalties and interest on \$1,600 of income he or she tried to avoid reporting.

In addition to the tax on the individual, the corporation will not be able to get any income tax relief for the benefit added to the shareholder's income. Since shareholder benefits are not tax-deductible, the corporation cannot deduct the \$1,600 amount which could have resulted in a savings to the corporation of about \$320 in corporate income taxes (assuming a 20% tax rate).

Careful tax planning can make good business sense and is constantly reinforced by the courts. On the other hand, the penalties and interest involved in tax avoidance are significant and may end up costing more than the entire benefit avoided.

I/R 2101.07

Corporate-Owned Life Insurance

For every decision in life, there is often a set of pros and cons that motivate us to carefully consider all aspects of the choice at hand. In reaching the final decision, it is not unusual to feel that you had to make a trade-off, whereby you gained a significant benefit while simultaneously foregoing something else. Corporate-owned life insurance is an example of one of these decisions. The shareholder will achieve certain benefits by causing his or her corporation to own the life insurance on his or her life, but the decision involves trade-offs that are worth noting.

The primary advantage of corporate-owned life insurance is that the premiums are funded from after-tax cash flow that has generally been taxed at a much lower level than the individual shareholder's tax rate. The corporate tax rate applicable to the lower level of active business income is somewhere between 11% and 19%, depending on the province of residence. The top individual marginal tax rate is somewhere between 39% and 50%, also depending on the province of residence.

The primary disadvantage of corporate-owned life insurance is the loss of protection from creditors. When an individual owns his or her own life insurance policy and names a beneficiary within a prescribed class, the policy may be exempt from seizure by the individual's creditors. Corporate-owned life insurance does not offer similar protection, and often a corporation could have a broader range of creditors. (This can sometimes be mitigated by having insurance owned by a holding company.)

The above two points are of importance during the lifetime of the person whose life is insured. Upon death, corporate-owned life insurance creates a credit to the company's capital dividend account (CDA). This credit can be used in several post-mortem planning strategies that could reduce the overall income tax liability triggered by death. However, corporate-owned life insurance can also increase the income tax liability upon death. The cash value of a life insurance policy will add to the value of the shares of the company, and could impact eligibility of the shares for the capital gains exemption. If the sole shareholder passes away when the company owns a life insurance policy on his or her life, the deeming rules of the Income Tax Act will set the value of the policy at its cash surrender value. The same deeming rule would apply to all corporate-owned life insurance policies on the lives of individuals related to the sole shareholder. The deeming rule is not effective for any other insurance policies, which would be valued at their fair market value, taking into account such items as the health of the insured life.

The issue that needs to be recognized is that the cash value of the life insurance policy will increase the value of the shares and, therefore, the income tax liability triggered by death. At the same time, corporate-owned life insurance will create a CDA credit that can be used to reduce the income tax liability triggered by death. Consider the following example of two corporations, both with a \$1,000,000 investment portfolio and a \$1,500,000 life insurance policy. The corporations differ in the amount of cash value associated with the corporate-owned policy.

	Situation A	Situation B
Investment Portfolio	\$1,000,000	\$1,000,000
Life Insurance	\$1,500,000	\$1,500,000
Cash value	0	\$500,000
Accrued income taxes	\$230,000	\$345,000
Taxes after planning	\$115,000	\$230,000

The above analysis assumes a personal effective tax rate of 46% on ordinary income and 32% on dividend income.

In the above example, the "extra" cash value attracted an extra \$115,000 of income taxes. Cash value can be important to the policyholder as a liquidation value or as collateral security. The issue to bear in mind is the added cost of carrying cash value on the books of the company.

Corporate-owned life insurance can be a good decision for many reasons, but it is important to constantly be aware that other issues will arise as a result of the decision.

I/R 5200.01

Budgeting

There was a time when a conversation about budgeting was completely unheard of, at least in “polite” public company. Canadians kept their money issues to themselves, and initiating conversations on this topic was generally considered invasive. Today, the topic of budgeting is everywhere around us, from lower school to post-graduate studies, and from home magazines to daily newspapers.

Budgeting is critical at all levels of society — from the lower-income segment through to the ultra-wealthy. Every family must prioritize where it is going to spend its income and how to make sure its income satisfies all of its needs. Financial disasters have affected many families from every level of income, but budgeting can help minimize the potential impact of a financial crisis.

Budgeting comes in many flavours and styles. Today, it is common for individuals and families to work with a financial planner to develop workable strategies that help accomplish specific needs and goals.

One common form of budgeting is to “pay yourself first”. Under this strategy, a savings target is first established along with a target date by which the funds will have been accumulated. Knowing how much you want to accumulate, and by when, is the starting place. Then, the amount that you need to pay yourself is calculated based on an assumed investment rate of return adjusted for income taxes, and the timeline for the savings goal. Once the periodic amount of savings has been identified and the plan put into action, the target savings are carved out of the family’s monthly cash flow, leaving the remainder available for consumption on lifestyle needs. In this way, all items that are beyond the family’s monthly cash flow are cancelled or deferred, with the result that the family should be able to stay in balance and achieve their financial goals. Note that to make this strategy balance, there needs to be a level of reasonableness in savings targets so that the remaining cash flow is sufficient to address all fundamental financial needs.

Savings goals could include some or all of the following: long-term goals such as retirement, medium-term goals such as children’s education or a new home or cottage, and shorter-term goals such as vacations or buying a new car or boat.

Another strategy for creating a family budget, often referred to as the “cookie-jar” method, involves reviewing spending habits to isolate how much money is needed to support different categories of spending. Components could include both necessities along with lifestyle activities — utilities, rent, mortgage, property taxes, food, clothing, child care, travel and entertainment. These components can start to be quantified by reviewing the spending history from the most recent couple of months and then critically reviewing what would be appropriate to spend on each component. If there is no breakdown of historical payments, a forward-looking approach is to track the spending in each of these areas over a two- to three-month period. Be warned, however, that while two months of expenditures is a place to start, families must also keep in mind that much spending is lumpy (insurance premiums, for example) or seasonal (for example, snow tires or gardening expenses, school supplies, vacations, gifts, etc).

How a particular family chooses to develop a budget will depend on the circumstances of the family and their ability and determination to stick to a plan. More important than the type of plan is the ability to stick to the plan and review it periodically to account for changes in family circumstances and goals. A financial planner can help not only in setting up the original budget plan but also in its periodic review and assessment of progress.

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